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How to Prepare for Stock-Option Backdating Investigations

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The government's investigation into the backdating of stock options for executives is expanding. Various media outlets report that there are up to 80 active investigations into dozens of companies relating to options backdating. The Internal Revenue Service has announced that it will examine relevant cases of stock-option backdating to make certain that corporations and executives met their tax obligations. The Department of Justice and the Securities and Exchange Commission have filed criminal and civil charges against executives at Brocade Communications Systems Inc. (and DOJ has now followed up with criminal charges against executives at Comverse Technology Inc.), suggesting that the investigations have progressed significantly.

Publicly traded companies that have not received notice of an investigation need to prepare for the possibility that such a notice might soon arrive. And even in the absence of scrutiny from government agencies, all publicly traded companies must consider how the announcement of investigations into these issues affects future public statements to the investing public.

The Brocade cases provide a glimpse at what the SEC and the DOJ are examining. The civil complaint[1] alleges fraud and misstatements in connection with the sale of securities and references Sarbanes-Oxley Act provisions governing failures of internal controls and the falsification of books and records. As factual support for the various allegations, the complaint describes how Brocade's CEO, CFO and vice president of human resources altered records, including committee minutes and personnel documents, to create the false appearance that options had been granted at an earlier date (and at a time when the stock price was lower) than the actual grant. It also claims that the executives made fraudulent entries into the company's financial records and made false and misleading statements to outside auditors in order to conceal these acts.

The Brocade criminal complaint[2] recites substantially similar factual allegations and charges that the defendants committed securities fraud by using the mail and the national securities exchanges to promote a scheme that violated provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. While the government will face a heightened burden of proof and different discovery rules in the criminal case, the basic elements of proof and available defenses will be similar.

To establish securities fraud charges, the government will have to prove that the defendants (1) perpetrated a fraud or deception, (2) with respect to a material fact, (3) in connection with the purchase or sale of a security, and (4) with *scienter* — an intent to deceive, manipulate or defraud.

There are a host of procedural and substantive defenses. For example, the applicable statute of limitations will preclude charges filed more than two years after the date of discovery and five years from the event. And because that statute was lengthened substantially by Sarbanes-Oxley, there could be arguments regarding the retroactive application of the statute. No liability attaches if the government is unable to prove that a statement was

false as a threshold matter or that a false statement concerned a matter about which a reasonable investor would attach importance. And because of the *scienter* requirement, a defendant cannot violate any of the applicable laws unless he or she intended to deceive or defraud at the time relevant acts were performed.

Interestingly, the SEC articulates a theory of motive in its complaint against Brocade, suggesting that the defendants used the alleged scheme to recruit and retain key employees. This theory was certainly included to anticipate the defense argument that the executives did not personally profit from the alleged practices. While motive is not an element of any of the listed offenses, the government may encounter problems before a jury if it is unable to establish that the charged executives personally profited.

It should be clear from this summary review of the Brocade case that charges arising from options backdating practices will be intensively fact-driven. As the SEC and DOJ probes continue and widen, government investigators will be looking for evidence that companies have engaged in practices similar to those found at Brocade and Comverse. If they find such practices, investigators and prosecutors will analyze the composition and roles of compensation committees and external auditors. Decisions to charge will be based, at least in part, upon the establishment of internal controls and corporate governance provisions.

As has been repeatedly proven in the past five years, companies will gain significant advantage by thoroughly investigating and reviewing option-related activity in advance of any government inquiry. Given the complexity of the issues involved and the fact-dependent nature of available defenses, public companies are well-advised to get ahead of these issues prior to contact by federal regulators or prosecutors.

Internal Investigations

Any public company that suspects it may have an issue with options grants should conduct an expeditious yet comprehensive review to facilitate an evaluation of potential risks. Because this issue has already drawn the attention of government attorneys and class-action plaintiffs' counsel, it will be critical to establish and maintain the legal protections that will allow the company to shield the results of its investigation from compelled production at a later date.

While the exact contours of the attorney-client privilege and work product doctrine vary among jurisdictions, the basic elements are consistent: The gathering and analysis of information must involve or be at the direction of an attorney, the inquiries and communications must be designed to obtain or provide legal advice in anticipation of litigation, and the materials must be maintained confidentially. If these steps are not followed, the company significantly risks losing control over the process and the results of its internal investigation.

Document Retention, Collection and Review

In the post-Arthur Andersen world, all companies, regardless of size, should have a comprehensive written document-retention policy that establishes a periodic schedule for document destruction and that removes employees from subjective preservation decisions. Ideally, that policy should also include a "safety valve" — a mechanism to suspend the destruction of documents immediately upon commencement of an internal investigation and/or notification of a government inquiry. At the start of any internal investigation, that safety valve should be triggered and a clear, written notification should go to all employees with access to relevant documents. The notification should be drafted with the knowledge that it may be provided at a later date to the government. A reliable preservation and collection procedure can be a critical tool in a company's effort to convince investigators to delay the issuance of subpoenas and to allow an internal investigation to continue without undue outside interference.

Once the safety valve is triggered, relevant documents must be collected and reviewed. Included in this review should be employment contracts, compensation committee minutes, options granting policies, corporate and individual tax returns, and any documents relating to individual's exercise of specific options. In addition, however, counsel will need to review drafts of all relevant final documents and search for e-mail traffic and other correspondence that relates to those drafts. Often, investigators focus on the changes in various documents and the chatter that surrounds those changes as much as the final product.

The retention of outside counsel to conduct this review can bolster privilege claims as outside counsel unquestionably serves in a "legal" capacity whereas in-house counsel may arguably serve in a privilege-compromising "business" capacity. The review should follow a written document collection and review plan — a plan that, like the preservation letter, should be drafted with the understanding that it may later be produced to government investigators in order to forestall the issuance of subpoenas.

The plan must resolve a number of threshold questions: Should investigators conduct the searches or should that be left to individual employees? Should relevant materials be segregated from general business records or merely

duplicated with a copy left in general records? Should a forensic expert be retained to assist in the recovery of electronic files? The resolution of these questions will influence the government's evaluation of the internal investigation and again may affect a company's ability to delay government intervention.

Electronic Documents and Files

Government investigators generally (and the Department of Justice specifically) are issuing far more comprehensive subpoenas regarding electronically stored documents than they did previously. Companies should expect that a subpoena issued by the DOJ or the FBI will likely seek an early conference between law enforcement agents and an information technology representative of the company. At that conference, the company representative may be asked to answer comprehensive questions about the company's hardware and software setups, network configurations, e-mail and electronic calendaring programs, data backup and archival procedures, and data recovery abilities. If the company representative is unable to provide concrete answers on these topics and assurances that relevant data and documents are being properly preserved and collected, the company runs a substantial risk of ceding control of any fact-finding efforts to the government.

Interviews of Company Employees

A comprehensive internal investigation will also likely include interviews of company employees. While there is a temptation to immediately commence interviews at the start of an investigation, those interviews will be less useful if the interviewers do not sufficiently understand the universe of relevant documents.

Ideally, a thorough review of the relevant documents would precede the start of interviews. While practical considerations often make that ideal impossible, interview preparation requires that counsel have at least an understanding of the documents authored by and/or reviewed by an interviewee because a first interview is often the best chance to elicit frank and unguarded information.

Similarly, in selecting the sequence of interviews, counsel should consider whether some interviews need to be conducted before others in order to uncover potential conflicts in recollections or
impeaching statements.

The start of employee interviews is critical because the investigator must both ensure that privileges are preserved and also give the employee fair notice of the issues involved in the interview. Thus, an introductory statement should inform the interviewee that:

- The interview is being conducted so that counsel can provide the company with legal advice;
- Counsel represents the company and not the employee;
- The interview is covered by the company's attorney-client and work product privileges and therefore, the employee should not discuss the interview with others;
- The company, and not the employee, may choose to waive those privileges in the future; and
- The company expects the employee to cooperate fully with the investigation and to tell the truth.

The recent guilty pleas of three former executives at Computer Associates to obstruction-of-justice charges in connection with statements they made during an internal investigation have led some to suggest that an employee should be warned that any statements made during the interview will likely be provided to the government and could be used as evidence against the employee in a future criminal proceeding.

The government's theory of criminal liability[3] was that the Computer Associates executives, who were not accused of lying directly to federal investigators or a grand jury, sought to mislead federal officials by lying to internal investigators who later passed the false information on to the government.

Whether a judge would accept the government's theory of liability in the face of a defense challenge remains unanswered. Regardless, a warning similar to that set forth above is unnecessary in an early-stage internal investigation, because such an investigation should not commence with an assumption that privilege will be waived or that information will be provided to the government. Indeed, counsel should stress that the company *may* waive the privilege in the future, but is unable to make that determination until the investigation has been concluded.

The form in which employee interviews are memorialized must also be carefully considered. The work product doctrine will protect non-verbatim accounts of interviews that reflect the thought processes of counsel. But counsel must always remember in drafting memoranda that there may come a time when the company decides to waive privilege and disclose the document to the government. Many cases have been unnecessarily complicated by the discovery of a lawyer's preliminary, subjective impressions carelessly stated in a memorandum as a solid conclusion.

Future Statements

Aside from preparing for a potential law enforcement inquiry, publicly traded companies need to conduct comprehensive fact-gathering regarding their options practices in order to satisfy future reporting obligations.

The SEC's new proxy disclosure rules effective at the end of the year will now identify executive options authorized on a date other than the grant date or having exercise prices different from fair market value at the grant date.

Companies will be required to explain in detail their granting policies, including whether option grants and pricing are coordinated with the release of good or bad news, the method by which exercise prices are determined, and the role of the board, compensation committee and executives in the granting process.

The SEC has publicly stated that the new rules are intended to shed more light on a company's granting and pricing policies to flush out "backdating," "spring-loading" or issuing options just prior to the announcement of good news, and other abusive practices.

The SEC, and the DOJ as well, will likely take the view that the present press coverage of backdating puts companies on notice that these issues exist. Accordingly, companies will be held to a high standard in issuing forthcoming proxy disclosures (and other statements relating to options), and misstatements will be viewed significantly more harshly.

Notes

[1] *SEC v. Reyes et al.*, No. 06-4435, *civil complaint filed* (N.D. Cal. July 20, 2006)

[2] *United States v. Reyes et al.*, No. 06-70450, *criminal complaint filed* (N.D. Cal. July 20, 2006)

[3] *United States v. Kumar et al.*, 384 F. Supp. 2d 562 (E.D.N.Y 2006); *United States v. Zar*, 384 F. Supp. 2d 562 (E.D.N.Y 2006).

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